

Addressing the FY10-14 Shortfall

Preserving Services and the Foundation for Economic Growth

The current recession has created a series of difficult choices for local governments around the country, as the map on page 23 illustrates. Many cities have resorted to deep reductions in services and staff to balance their budgets. The Administration has carefully considered its options for balancing the FY10 budget, just as it carefully considered the measures it implemented in the November 2008 rebalancing plan. The Administration has prioritized the collection of unpaid and delinquent taxes, implemented efficiencies in the delivery of services to residents and workers who commute into Philadelphia, and sought a series of concessions from employee unions in order to lower the cost of municipal services. As described earlier, the Administration will continue to pursue these priorities in the FY10-14 balancing plan because Philadelphians deserve the most effective and productive workforce and city services that can be provided.

However, the deepening recession has made it impossible to close the emerging budget shortfall solely through actions designed to make Philadelphia's government more efficient. The Administration's plan to close the shortfall, relies on \$30.6 million in annual reductions to services, \$14.5 million in annual efficiencies, \$16.4 million in increased fee revenue, totaling \$296.5 million over 5 years, and over \$300 million in labor concessions and salary freezes that the Administration is seeking from the City's employee unions over the Five Year Plan. Unfortunately, the \$600 million in savings over 5 years that these actions will produce, along

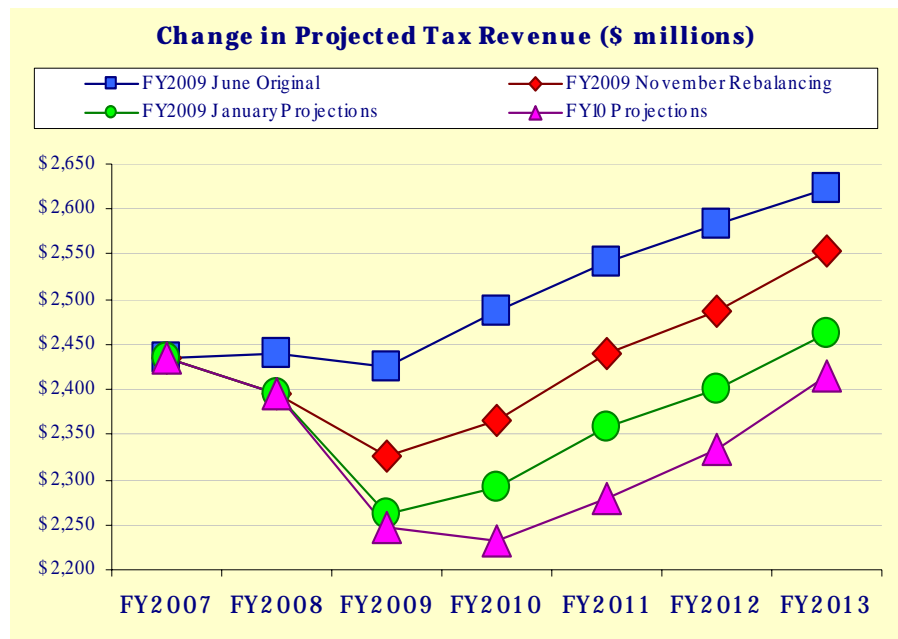
with \$331 million in savings associated with changes in the City's pension contribution formula, is insufficient to address the City's projected shortfall. Consequently, the Administration must raise taxes to close the remaining portion of the shortfall.

The decision to raise taxes was not taken lightly, especially since the November 2008 suspension of rate reductions in the wage tax and the business privilege tax raised \$230 million in revenue between FY09 and FY13. However, the damage to the City's economy that would occur if the Administration tried to close the remaining gap with service reductions or additional wage and business privilege tax increases would be severe and long-lasting. Closing the gap solely with expenditure reductions would require an additional \$222 million in annual reductions in FY10 and FY11, which would decimate the City's core services and damage the city's economy as a number of studies have argued. For example, Upjohn Institute economist Timothy Bartik observes that, "public services can

actually increase state and local growth,"^{iv} while New York University and former World Bank economist William Easterly believes that, "governments can kill growth by doing ... too little public service provision."^v Similarly, as Wharton economist Robert Inman has found, high levels of taxation on wages and businesses have driven jobs and businesses from Philadelphia, to the detriment of the City's economy.^{vi}

The Administration believes that temporary tax increases provide the best option to preserve Philadelphia's core services until the national and local economies rebound and revenue growth returns to some measure of its pre-recessionary levels. And the temporary nature of the increase in rates will limit the damage that would otherwise be done to long-term economic growth if deeper service reductions or higher wage and business taxes were enacted.

The graph below shows the significant losses to the City's projected tax revenue from FY07 to FY13, as of March 2009.



Cash management

Managing the City's cash flow is of critical importance in preparing the budget. The Budget Office forecasts monthly cash flows, estimating receipts and disbursements each year over the five year plan. Without these estimates, the City would not know how much is needed for its operations and how much money will be required to support its planned spending.

With a large budget such as Philadelphia's, the balance each month should be above \$100 million in order to ensure that it will not run out of cash to pay its employees, contracts and other expenditures as large payments can lead to substantial swings in daily cash balances. However, with the recession creating dramatic losses in revenues, the City has forecast that without intervention, either through departmental cuts or increased revenue, the City could have run out of cash before the end of calendar 2009. In order to balance the FY10 budget and FY10-14 Five Year Plan and prevent this devastating situation from occurring, the City has looked to short-term, phased out tax increases to fill the projected gaps while meeting its cash needs. (See page 32 for more information.)

Departmental Balancing Actions

Each department submitted a proposal outlining how they may reduce spending or raise revenue to meet a 10%, 20% or 30% reduction in their department's funding.

The submissions generated several different options for the Mayor. Some departments suggested innovative revenue ideas, such as charging a fee for trash collection from commercial establishments, while others focused on preserving their core department functions and reducing the items that were not deemed to be their priorities.

From these lists, and with input

from citizens and employees, the Mayor found savings of \$60.6 million each year for the life of the plan from departmental reductions and fee increases. Details of all balancing actions are provided in Appendix II.

Efficiencies

From these departmental reductions, the City estimates that **\$14.5 million** can be generated annually through efficiencies. These include:

- Overtime reduction—**\$2 million** (Police, Recreation, Public Property, Licenses and Inspections)
- Sustainable litter basket (discussed on pages 46-48)—**\$875,000**
- Waste minimization (discussed on pages 46-48) —**\$2 million**
- Incentive Based recycling (discussed on pages 46-48)—**\$1.5 million**
- Fleet reduction—**\$1.5 million**
- Energy efficiencies across departments (see page 48)—**\$1.5 million**
- Instituting a utilization review process related to prescription medications—**\$1.125 million**

Fee Increases:

The City plans on generating almost **\$16.4 million** annually through new fees and fee increases. Some examples include:

- Increasing fire EMS fees to bring in **\$5 million** in revenue
- Enacting fees for commercial trash collection, bringing in **\$7 million** in revenue
- Increasing fees in the Records department by \$30, generating **\$2.4 million** in revenue
- Charging a sliding-scale fee for uninsured patients at the City's Health Centers, generating **\$766,500**

Reductions

Over **\$30 million** in departmental reductions have also been generated. Some of the major changes to Departmental budgets include:

- Reducing demolitions, saving the City **\$2.1 million**
- Freeze civilian police hiring, saving over **\$700,000**
- Eliminating some over-the-counter medications at City Health Centers, saving **\$375,000**
- Eliminating approximately 250 positions, saving more than **\$11 million**

What the City Learned from Public Engagement

In their Executive Summary, the organizers of the Community budget workshops, write that a consistent theme emerged among citizens: they would accept tax and fee increases if it meant the preservation of core services, including public safety, health, and housing. Citizens also expressed a preference that layoffs should be a last resort – the Administration should continue to find efficiencies and consolidations wherever possible. Lastly, participants were enthusiastically supportive of the Administration tackling several long-term challenges, including pensions and healthcare.

Citizen feedback has been a crucial factor in this year's budget process. Suggestions and feedback from employees and residents have helped inform the decisions proposed in this Five Year Plan.



Mayor Nutter seeks input on the budget at a beauty salon in Germantown

Labor Agreements

The City’s labor agreements with its four major bargaining units expire on June 30, 2009. As part of the overall strategy for addressing the City’s \$1.04 billion five year plan deficit, the cost of wages and benefits for City employees must decrease by at least \$25 million in the first year of the plan, and by at least \$125 million over the life of this Five Year Plan. Dividing that \$25 million among the four unions (along with exempts and non-represented employees) based on their percentage of the current City payroll, requires annual reductions of Fraternal Order of Police costs by at least \$8.7 million, the International Association of Fire Fighters costs by at least \$2.7 million, and AFSCME District Councils 33 and 47 costs by a combined total of at least \$9.1 million. Exempt employees costs would be reduced by at least \$3.3 million and non-represented employees costs would be reduced by at least \$1.2 million.

Although wage freezes can slow the growth of payroll overall, such steps will not be enough to achieve the significant savings in the City’s employment costs that the City’s financial situation requires. Rather, achieving a balance between the employment needs of workers and the City’s ability to continue to provide key services to the public requires an actual reduction in the per employee cost of wages and benefits. Toward that end, the City proposes a number of changes that seek to bring the benefits of the City’s workers more in line with those of the City’s citizens and taxpayers, give the City greater flexibility to be smarter and more efficient in the provision of City services and reduce unnecessary costs, including excess overtime.

This includes achieving long-term savings through a new pension plan for newly-hired and non-vested employees. As part of the Administration’s proposal to generate these savings, the City is submitting an

application to the Pennsylvania Employee Retirement Commission to have Philadelphia’s pension fund declared “severely distressed” – the highest level of distress. Along with that declaration of severe distress comes an obligation to make significant changes to the pension fund to reduce employee costs. This new plan will provide a guaranteed level of benefits - lower than the benefits under the current plan - to employees who work for the City for a number of years and allow those who want higher benefits to contribute more of their own money and have the City match a portion of it.

The City also proposes changes in health benefit plans to reduce costs in both the short and long-terms. In addition, the City is seeking immediate relief from its current pension liability by proposing higher levels of contributions by existing employees towards their future pension benefits.

Other immediate cost savings proposals target elimination of expensive contract provisions including: the requirement that all Police Officers and Fire Fighters be guaranteed vacation during the limited summer months, as opposed to distributing leave time year round, leading to high overtime costs to replace vacationing employees; limitations on the City’s ability to change work schedules efficiently; staffing mandates; and guaranteed overtime far above what the law requires. Similarly, the City seeks to reduce the number of paid holidays from an extraordinarily high twelve holidays (including each Police Officer’s birthday) to nine holidays.

Wage Reserve Eliminated

The Five Year Plan for FY09-13 allocated \$402.9 million over the five years of the Plan in a separate line for funding wage and/or benefit increases that had not yet been negotiated with the City’s employee bargaining units. With the FY10-14 Plan, this reserve has been completely eliminated.

Changes in the Pension Fund Assumptions

Another way the City is seeking to generate savings over the FY10-FY14 plan is by making actuarial changes to its pension fund assumptions. In February 2009, the Philadelphia Board of Pensions and Retirement proposed to lower the assumed return on the pension investments from 8.75% to 8.25% and spread out the fund’s earnings and losses from five to 10 years, provided that a 40 year amortization schedule for the payment of Philadelphia’s unfunded liability is enacted into Pennsylvania law.

The estimated savings of these changes total over \$330 million to the City’s General Fund, assuming a 30% loss on the pension fund’s earnings during FY09. The net impact of all three steps of these pension changes will be to lower the amount the City is required to contribute to the pension fund over the next five fiscal years, and increase its ability to fund existing liabilities in the long-term.

The proposed changes to the pension fund assumptions have been tested by the City’s actuary and have been determined to be actuarially sound. According the City’s actuary, “each of these changes is individually supportable and in the aggregate provides a system of funding that recognizes the current funded status and implications for the City while providing a long-term approach to meeting the obligations to continue to provide retirement benefits.”

Projected Savings from Changes in Pension Fund Assumptions	
	\$
FY10	-\$932,000
FY11	\$130,943,000
FY12	\$60,210,000
FY13	\$72,166,000
FY14	\$69,254,000
Total	\$331,640,000

Additional Pension Initiatives

In addition to the pension cost-savings the City seeks to achieve through labor negotiations and changes to pension fund assumptions (see previous page), additional efforts to reduce costs and strengthen the health of the pension fund are being pursued:

- **Deferred Retirement Option Plan (DROP) Account Balance Interest Rate**

The Administration transmitted legislation to City Council in mid-March to change the interest rate applied to DROP account balances from a fixed rate to a variable, capped rate. The guaranteed earnings rate on DROP accounts is now a fixed 4.5%, which is damaging during years when the market decreases. The legislation introduced would ensure that the earnings rate for the accounts will equal the earnings rate for the pension fund for the previous year, with a cap of half of the pension fund's assumed earnings rate. This modification to a variable DROP earnings rate with a cap protects the health of the fund in years when earnings are weak.

- **Pension Adjustment Fund Contributions**

Another bill introduced in mid-March would amend the provisions governing when contributions are made into the Pension Adjustment Fund. Those contributions are used to provide cost of living adjustment for pensioners. If passed, the legislation would reinstate the minimum funding level established as of July 1, 1999 – a level of 76%– before any contribution to the pension adjustment fund would occur. The legislation would also require that the valuation of the pension fund, for cost-of-living adjustment purposes, be done using a ten-year rather than a five-year period. Spreading out the pension fund's losses/earnings from five years to ten years protects the pension fund's health because it eliminates dramatic fluctuations from year to year.

The pension fund is only funded at roughly 55% and, as a result of this year's market losses, that funding percent is likely to decline further. Because there is currently no minimum funding level requirement for the pension fund, the pension fund has been required to contribute more than \$65 million to the pension adjustment fund over the past two years (FY08 and FY09). While these costs cannot be recouped with the proposed legislation, the proposed changes can improve the future health of the pension fund by assuring that contributions are made only when the pension fund is healthy enough for such added obligations.

- **Elected Officials and DROP**

The Administration transmitted legislation to City Council in late-March to terminate elected officials' eligibility to enroll in the Deferred Retirement Option Plan (DROP). In large part, DROP was intended to provide the City with the ability to do succession planning for employees because once an employee enters DROP, that employee will leave City employment within a defined period of time. That benefit does not exist with elected officials whose tenure is decided by the voters. The Administration has consistently maintained that it is not appropriate for elected officials to enter the DROP and strong feedback from the public during community budget workshops reinforced that view. If adopted, the legislation would be effective January 1, 2010.

- **Annual Report on the State of DROP**

Together with legislation to terminate elected officials' eligibility in DROP, the Administration transmitted legislation to City Council in late-March to require that the Pension Board produce an annual report on the state of DROP no later than 60 days after the close of each fiscal year. If adopted, the report will include recommendations for retaining, revising, curtailing or terminating DROP.

- **Impact Study of DROP**

In mid-March, the City issued a Request for Proposals (RFP) for an impact evaluation of Philadelphia's DROP program. The purpose of the RFP is to commission a study to determine the effect of DROP on employee behavior. The results will be used to determine if the program is achieving its intended goals, its net cost, and whether it should continue in its current form.

Temporary Revenue Increases

As part of the plan to balance the FY10 budget and FY10-14 Five-Year Plan the Administration is proposing two temporary tax increases: an increase in the sales tax from the current 7% to 8% for FY10 through FY12 or from July 1, 2009 to June 30, 2012; and an increase in the property tax from 82.64 mills per \$100 of assessed value to 98.64 mills

Revenue Enhancements for FY10-14 (in thousands)						
	FY10	FY11	FY12	FY13	FY14	Total
Temporary Property Tax increase	\$153,934	\$117,694	-	-	-	\$271,628
Temporary Sales Tax Increase	\$106,475	\$116,514	\$118,716	-	-	\$341,705

for FY10, followed by a reduction to 94.64 mills in FY11, with a reduction back to the FY09 level of 82.64 in FY12.

The table above shows the main revenue enhancements used to balance the FY10-14 budget.

Temporary Sales Tax Increase

To balance the Five Year Plan, the Administration has proposed to temporarily increase the City portion of the sales tax from 1% to 2%. The effective sales tax rate in Philadelphia will therefore rise from 7% to 8% for FY10 through FY12. Beginning in FY13, the sales tax rate will revert back automatically to 7%. This proposed sales tax increase requires State authorization.

According to current revenue projections, a 1% sales tax increase for

Estimated Annual Sales Tax Burden for a Hypothetical Family of Three in Philadelphia, 2007			
	Current 7% Sales Tax Burden Amount	Change in Burden with 1% Increase	Sales Tax Burden Amount with a 1% Increase
\$25,000 family income	\$566	\$81	\$647
\$50,000 family income	\$803	\$115	\$918
\$75,000 family income	\$1,046	\$149	\$1,195
\$100,000 family income	\$1,491	\$213	\$1,704
\$150,000 family income	\$1,645	\$235	\$1,880

Source: Government of the District of Columbia, (August 2008) "Tax Rates and Tax Burdens - in the District of Columbia - A Nationwide Comparison. 2007"

FY10 through FY12 will generate \$341.7 million in revenue for the General Fund.

Temporary Property Tax Increase

As part of the City's effort to protect core city services while closing the \$1.04 billion shortfall, the Administration has proposed a temporary real estate tax increase of 16 mills for FY10 and a 12 mill increase for FY11. Currently, Philadelphia's real estate rate is 82.64 mills, divided between 33.05 mills for the City and 49.59 mills for the School District of Philadelphia.

The proposed temporary tax rate increase will change that rate from 82.64 mills to 98.64 mills for FY10 and 94.64 mills for FY11. Beginning in FY12, the real estate tax rate will revert back to 82.64 mills.

According to current revenue projections, a 16 mill real estate tax increase for FY10 and a 12 mill increase for FY11 will generate \$271.6 million in savings for the General Fund.

The City has analyzed the

Estimated Annual Real Estate Tax Burden for a Hypothetical Family of Three in Philadelphia, 2006					
	Current 82.64 mill Real Estate Tax Burden	Additional Tax Burden		New Real Estate Tax Burden	
		16 Mill Increase	12 Mill Increase	16 Mill Increase	12 Mill Increase
\$25,000 family	\$1,577	\$305	\$229	\$1,882	\$1,806
\$50,000 family	\$2,303	\$446	\$334	\$2,749	\$2,637
\$75,000 family	\$2,532	\$490	\$368	\$3,022	\$2,900
\$100,000 family	\$2,840	\$550	\$412	\$3,390	\$3,252
\$150,000 family	\$3,490	\$676	\$507	\$4,166	\$3,997

Note: Property taxes are based on 20% of estimated annual rent at the \$25,000 level. Source : Government of the District of Columbia, (November 2007) "Tax Rates and Tax Burdens - in the District of Columbia - A Nationwide Comparison. 2006"

estimated tax burden residents will face by 16 and 12 mill temporary increases in the real estate tax rate. The table above shows the annual impact of the

16 and 12 mill increases on the average family in Philadelphia depending on family income levels.

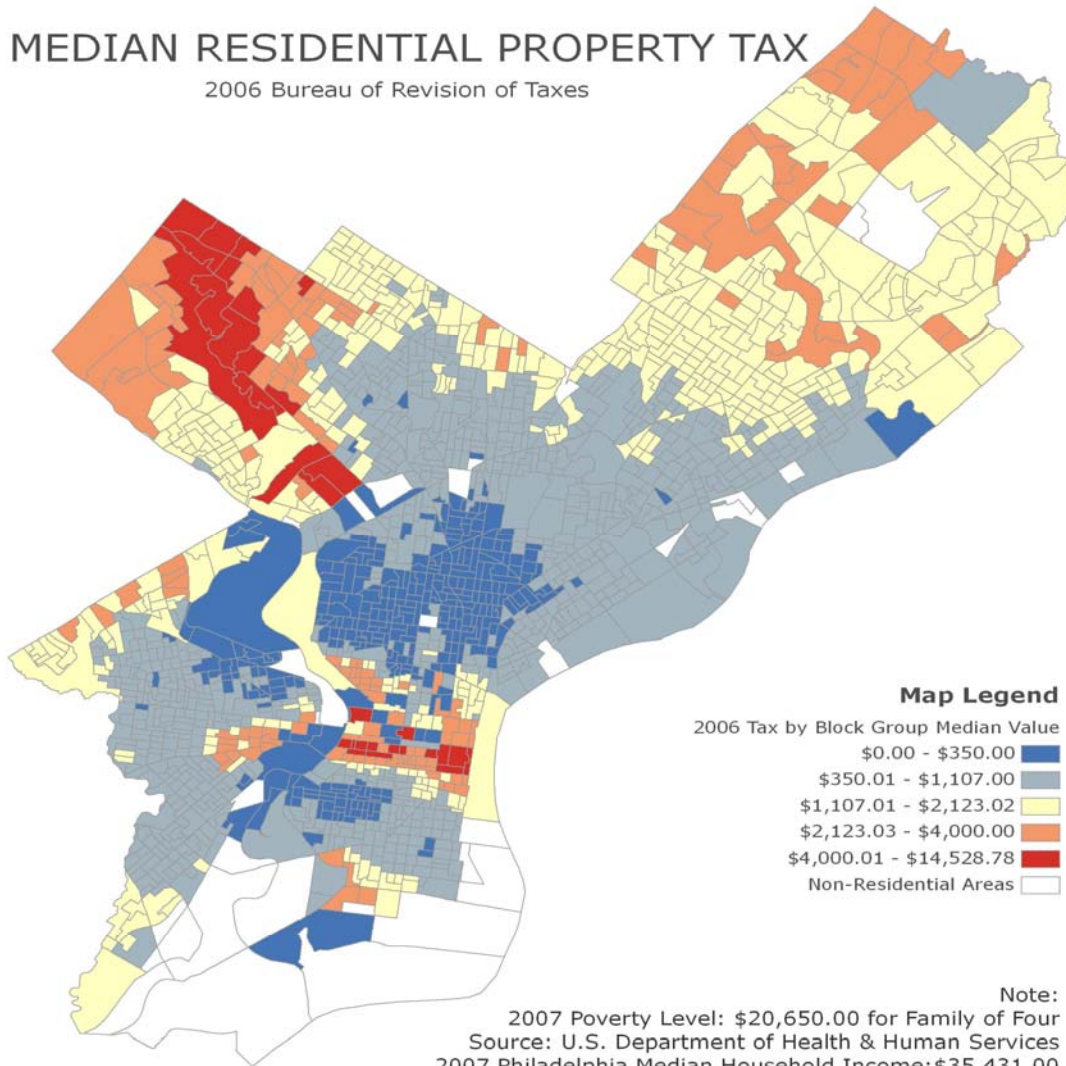
Using data from the U.S. Census and the City's Board of Revision of Taxes, the annual impact of a 16 mill real estate tax increase on sample homes in different areas of Philadelphia are shown below.

Estimated Annual Real Estate Tax Burden for Sample Homes in Philadelphia

Philadelphia Neighborhood	2006 Assessed Value	2006 Property Tax	2010 Property Tax with increase of 16 mills,	Estimated increase in property tax, 16 mills
Chestnut Hill	\$80,518.72	\$6,654.07	\$7,942.37	\$1,288.30
Rittenhouse	\$53,421.16	\$4,414.72	\$5,269.46	\$854.74
West Mount Airy	\$37,827.80	\$3,126.09	\$3,731.33	\$605.24
Somerton	\$25,739.33	\$2,127.10	\$2,538.93	\$411.83
Pennypack	\$21,257.86	\$1,756.75	\$2,096.87	\$340.13
Roxborough	\$19,576.45	\$1,617.80	\$1,931.02	\$313.22
Overbrook	\$16,399.31	\$1,355.24	\$1,617.63	\$262.39
Pennsport	\$10,932.87	\$903.49	\$1,078.42	\$174.93
Wharton	\$9,666.82	\$798.87	\$953.53	\$154.67
Cobbs Creek	\$8,350.48	\$690.08	\$823.69	\$133.61
Hunting Park	\$4,319.22	\$356.94	\$426.05	\$69.11
Strawberry Mansion	\$3,391.38	\$280.26	\$327.74	\$47.48

MEDIAN RESIDENTIAL PROPERTY TAX

2006 Bureau of Revision of Taxes



Map Legend

- 2006 Tax by Block Group Median Value
- \$0.00 - \$350.00
- \$350.01 - \$1,107.00
- \$1,107.01 - \$2,123.02
- \$2,123.03 - \$4,000.00
- \$4,000.01 - \$14,528.78
- Non-Residential Areas

Note:

2007 Poverty Level: \$20,650.00 for Family of Four
 Source: U.S. Department of Health & Human Services
 2007 Philadelphia Median Household Income: \$35,431.00
 Source: U.S. Census Bureau